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**CITY OF MILPITAS**  
**MEMORANDUM ON INTERNAL CONTROL**  
**AND**  
**REQUIRED COMMUNICATIONS**  
**FOR THE YEAR ENDED**  
**JUNE 30, 2009**

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**CITY OF MILPITAS  
MEMORANDUM ON INTERNAL CONTROL  
AND  
REQUIRED COMMUNICATIONS**

**For the Year Ended June 30, 2009**

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## MEMORANDUM ON INTERNAL CONTROL

September 18, 2009

To the City Council of  
the City of Milpitas, California

In planning and performing our audit of the financial statements of the City of Milpitas as of and for the year ended June 30, 2009, in accordance with auditing standards generally accepted in the United States of America, we considered the City's internal control over financial reporting (internal control) as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the City's internal control. Accordingly, we do not express an opinion on the effectiveness of the City's internal control.

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the City's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the City's financial statements that is more than inconsequential will not be prevented or detected by the City's internal control.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the City's internal control.

Our consideration of internal control was for the limited purpose described in the first paragraph and would not necessarily identify all deficiencies in internal control that might be significant deficiencies or material weaknesses. However, we noted no matters that we consider to be material weaknesses.

Included in the Schedule of Other Matters are recommendations not meeting the above definitions that we believe to be of potential benefit to the City.

The City's written responses included in this report have not been subjected to the auditing procedures applied in the audit of the financial statements and, accordingly, we express no opinion on them.

This communication is intended solely for the information and use of management, City Council, others within the organization, and agencies and pass-through entities requiring compliance with generally accepted government auditing standards, and is not intended to be and should not be used by anyone other than these specified parties.

*Maze & Associates*

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**CITY OF MILPITAS  
MEMORANDUM ON INTERNAL CONTROL**

**SCHEDULE OF OTHER MATTERS**

**2009-01      Review and Approval of Journal Entries**

Journal entries prepared by one employee should be reviewed for accuracy and approved by a second employee. We selected a sample of thirty journal entries to test the effectiveness of journal entry processing, procedures and the adequacy of documentation. One of the journal entries tested was prepared, approved and posted to the general ledger system by the Accounting Manager without a second person's review. The City does not have a second employee designated to review the Accounting Manager's journal entries. Without this second review, errors in the journal entries could go undetected, or unauthorized journal entries could be posted.

To ensure proper control over journal entries and segregation of duties, the City should designate a second person, such as a Senior Accountant to review and approve the entries initiated by the Accounting Manager. As a second alternative, since the Accounting Manager is the only employee authorized to post journal entries, the City's procedures could be revised to exclude her from preparing journal entries.

***Management's Response:***

If the Accounting Manager should initiate a journal entry, a second person, such as a Senior Accountant will review and approve the entries.

**2009-02      Building Permit Fee Calculation Errors**

We selected a sample of 30 building permit fees to recalculate the rates charged in accordance with the City Council-approved rate schedule and noted the following:

- a. Ten of the receipts tested included a charge of \$45 for circuit breaker units. We understand it is the City's practice to charge \$45 for every circuit breaker unit, however the fee included in the Council-approved fee schedule is \$45 for the first two (2) circuit breaker panel/subpanels, and \$45 for each additional circuit breaker unit.

The City issued 16 permits from July 1, 2008 to April 17, 2009 that included this fee which resulted in a total of \$720 that was overcharged to customers. The permit system was corrected on April 17, 2009.

Although this error is not as significant as those discovered in prior year comment 2008-01, City staff should ensure that all fees included in the building permit system correspond directly to the Council-approved fee schedule. Subsequent revisions made to the Council-approved fee schedule that are updated in the building permit system should be verified for accuracy.

- b. It is the City's practice to charge the plan check fee and Title 24 fee initially based on the estimated project value. After the final project value is determined, the inspection fee is based on that value, and the impact of any difference in the value on the plan check or Title 24 fee is applied to the inspection fee (either an addition or reduction). Three of the receipts tested had a change in value and we found that the change in the plan check fee had been applied to the inspection fee for the three receipts, but the change in the Title 24 fee had been applied for only two of the receipts. Therefore, a credit of \$80 is due to the developer.

**CITY OF MILPITAS  
MEMORANDUM ON INTERNAL CONTROL**

**SCHEDULE OF OTHER MATTERS**

**2009-02      Building Permit Fee Calculation Errors (Continued)**

Although this credit is not a significant balance, the City should ensure that all fee credits are applied to permits during the recalculation process. The City should ensure that all calculations are reviewed by a second person to reduce the likelihood of errors.

***Management's Response:***

- a. City has corrected the fee on the system on April 17, 2009 and has reviewed all the fees individually in the system. The City has refunded the \$720 to the sixteen electrical permit applicants.
- b. The City no longer issues credits for valuation adjustments and instead issues a refund to the applicant.

**2009-03      Investigation of Investment Pools**

For both LAIF and Money Market Fund investments, the Authorized Investments Section of the City's Investment Policy requires that the City perform a "thorough investigation of the investment pool on a continual basis". The pooled fund that the City invests in is required to update their responses to an Investment Pool Questionnaire to ensure that the criteria for "qualifying these investment pools remain unchanged." The Accounting Technician reviewed the money market mutual fund's (Dreyfus) semi-annual report and the LAIF's pooled fund information online, however, that review was not documented and he did not update the Investment Pool Questionnaire as required by the Investment Policy. Therefore, the City is not in compliance with its own Policy. The City should document any reviews performed and update the Questionnaire as required by the Policy, or modify the Investment Policy to reflect the current practices.

***Management's Response:***

The City will document any reviews performed and has modified the fiscal year 2010 Investment Policy to remove the Questionnaire requirement.



CITY OF MILPITAS  
MEMORANDUM ON INTERNAL CONTROL

SCHEDULE OF OTHER MATTERS

**NEW GOVERNMENTAL ACCOUNTING STANDARDS BOARD PRONOUNCEMENT:**

The following comment represents a new pronouncement taking affect in the next few years. We cite it here to keep you abreast of developments:

**2009-04      GASB Statement No. 54 - *Fund Balance Reporting and Governmental Fund Type Definitions* (Effective for fiscal 2010/11)**

This Statement establishes fund balance classifications that comprise a hierarchy based primarily on the extent to which a government is bound to observe constraints imposed upon the use of the resources reported in governmental funds.

The initial distinction that is made in reporting fund balance information is identifying amounts that are considered **nonspendable**, such as fund balance associated with notes receivable. This Statement also provides for additional classifications as **restricted, committed, assigned, and unassigned** based on the relative strength of the constraints that control how specific amounts can be spent.

The **restricted** fund balance category includes amounts that can be spent only for the specific purposes stipulated by constitution, external resource providers, or through enabling legislation.

The **committed** fund balance classification includes amounts that can be used only for the specific purposes determined by a formal action of the government's highest level of decision-making authority. Amounts in the **assigned** fund balance classification are intended to be used by the government for specific purposes but do not meet the criteria to be classified as restricted or committed. In governmental funds *other than the general fund*, assigned fund balance represents the remaining amount that is not restricted or committed.

**Unassigned** fund balance is the residual classification for the government's general fund and includes all spendable amounts not contained in the other classifications. *In other funds*, the unassigned classification should be *used only to report a deficit balance* resulting from overspending for specific purposes for which amounts had been restricted, committed, or assigned. Governments are required to disclose information about the processes through which constraints are imposed on amounts in the committed and assigned classifications.

Disclosure of the policies in the notes to the financial statements is required.

This Statement also provides guidance for classifying stabilization amounts on the face of the balance sheet and requires disclosure of certain information about stabilization arrangements in the notes to the financial statements.

The definitions of the general fund, special revenue fund type, capital projects fund type, debt service fund type, and permanent fund type are clarified by the provisions in this Statement. Interpretations of certain terms within the definition of the special revenue fund type have been provided and, for some governments, those interpretations may affect the activities they choose to report in those funds. The capital projects fund type definition was also clarified for better alignment with the needs of preparers and users. Definitions of other governmental fund types also have been modified for clarity and consistency.

***Management's Response:***

The City will implement the provisions of the Statement in fiscal year 2011.

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**CITY OF MILPITAS  
MEMORANDUM ON INTERNAL CONTROL**

**STATUS OF PRIOR YEAR SCHEDULE OF SIGNIFICANT DEFICIENCIES**

**2008-01      Building Permit Fee Calculation Errors**

We selected a sample of 25 building permit fees to recalculate the rates charged in accordance with the City Council-approved rate schedule. We found that three permits were calculated incorrectly based on a formula-driven fee in the permits system.

Certain fees, including plan check, inspection, Title 24 and the permit automation, for commercial property greater than 50,000 square feet are calculated using the "valuation" method, rather than a flat-fee. Based on the valuation method approved by Council, for the first \$500,000 of "value", a fixed amount of \$8,900 is charged and \$12.80 is added for each additional \$1,000 of value or fraction thereof. However, the master rate in the permitting system was erroneously set with a base threshold of \$50,000 instead of \$500,000. We were told that the rate schedule from the City's old permitting system was migrated to the new system in March 2007.

Since the fee schedule was approved by Council in September 2004 and revised in July 2006, the building permit fees for properties over 50,000 sq. ft. after this period could have been mischarged based on the incorrect parameter, resulting in possible overbillings of permits fees by the City.

Based on the results of our findings, City staff recalculated all permits from February 2005 for projects that meet the above criteria and found that the overbillings for that period totaled \$136,753. Although this total is not significant, the potential for overbilling customers was significant.

Any time fee schedules or fee systems are revised, calculations should be manually checked to ensure that revised fee schedules or the automated systems are functioning properly.

***Current Status:***

The Building and Safety Department has corrected the building permit fee schedule for large projects with the construction valuation over \$500,000 and over 50,000 square feet of the area of construction. All large projects currently submitted to the City will no longer be overcharged based on previous erroneous fee formula in permitting software.

The Building and Safety Department provided an internal audit of the fees charged for all the permit applications for large projects submitted to the City after September 2004. It was determined that a total of 23 permits were issued with incorrect amount of permit fees charged.

The Building and Safety Department mailed notification letters to the permit applicants stating that they qualify for the refund of the overcharged fees.

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**CITY OF MILPITAS  
MEMORANDUM ON INTERNAL CONTROL**

**STATUS OF PRIOR YEAR SCHEDULE OF OTHER MATTERS**

**2008-02      Timely Bank Reconciliations**

Bank reconciliations are one of the most important internal controls a City can have. The January 2008 Bank reconciliation was not completed until April 2008. We understand that the City monitors the activity in its bank accounts on daily basis. However the reconciliation to the general ledger does not take place on a monthly basis. To be an effective control, bank reconciliations must be completed in their entirety as soon as reasonably possible after each month-end, usually within 30 days. Errors and unreconciled differences must be researched, understood and corrected immediately, or they will cause additional errors. Differences which result from program or procedural errors, such as misposted journal entries, are especially important because their underlying cause must be corrected to prevent more of the same error.

In addition, the UCC regulations require timely bank reconciliations and notification in order for banks to indemnify the City for losses due to fraudulent disbursements due to check fraud. We recommend that the City perform its bank reconciliations in a timely manner.

***Current Status:***

The City is enforcing the completion of its bank reconciliation within 30 days of month end.

**2008-03      Payroll Personnel Pay Review**

Timesheets are entered into the payroll system by each department, and then the payroll staff reviews and approves the timesheets in the system. As an added measure, the timesheets/pay checks of key finance personnel, including the Accounting Manager and the Senior Accountant, are reviewed to ensure that they do not include inappropriate amounts. However, no one reviews the payroll personnel's timesheets or pay checks to insure that their timesheets have not been altered during the review and approval process. The City should have someone other than the payroll staff to review payroll staff's timesheet and pay checks to ensure they include only appropriate and authorized amounts.

***Current Status:***

We have implemented a procedure for the Senior Accountant to review the payroll staff's timesheet and pay checks to ensure they are correct.

**CITY OF MILPITAS  
MEMORANDUM ON INTERNAL CONTROL**

**STATUS OF PRIOR YEAR SCHEDULE OF OTHER MATTERS**

**2008-04      Capital Assets Disposals and Auction Proceeds**

During our inquiry regarding the procedures in place for the accounting for disposition of capital assets, we selected two dispositions for testing. We found that the two motor vehicles were sent to auction in October 2007, however the proceeds from the sale of the assets had not yet been received as of June 2008. The City should establish a procedure to ensure the timely follow up and determination of the cause of the delay in the receipt of auction proceeds.

***Current Status:***

The City received a default judgment against the vendor and the City is in the process of sending the account to collections. The City has developed new procedures that ensure that auction proceeds are remitted directly to the City.

**2008-05      Information Technology Best Practices Recommendations**

We conducted an Information Systems Review with our audit which encompassed the financial information system and the network environment that houses it. We expanded our work in previous years beyond simply looking at financial information systems as a result of greater risks of unauthorized access caused by overall industry growth of web-based commerce and internet based financial systems. Internal controls that are present in the overall network environment have become more important and relevant to understanding the internal controls over the financial system. We believe Information System controls must be continuously improved and enhanced to stay ahead of the ever increasing sophistication of hackers and criminals.

Currently, there are no Information Technology standards to which local governments are required to conform. Indeed there are a wide variety of informal guidelines and suggested controls from many different organizations which local governments can use to implement appropriate controls to ensure adequate security over information technology. Our Information Technology staff have reviewed these informal guidelines and concluded that the certification and accreditation framework developed by the National Institute of Standards and Technology (NIST) for the Federal Information Security Management Act (FISMA) are the most appropriate for local government. NIST and FISMA represent the minimum security requirements for federal government agencies information systems. We understand the U.S. Department of Justice recommends these for local governments. Our procedures included performing an external network scan based on NIST criteria and in determining that internal control provides for:

- Internet access defenses including hacker prevention, detection and deterrent systems
- Security of data from physical or network access
- Adequately protecting data from unauthorized internal access
- Reasonable measures to ensure continuation of service

While the results of our work did not indicate material weaknesses, we did find exploitable vulnerabilities, and we noted a few areas which could be improved to conform to NIST guidelines. A summary of these recommendations which we believe are "best practices" are as follows:

**CITY OF MILPITAS  
MEMORANDUM ON INTERNAL CONTROL**

**STATUS OF PRIOR YEAR SCHEDULE OF OTHER MATTERS**

**2008-05      Information Technology Best Practices Recommendations (Continued)**

- *External Scan Results* -- Our external scan found two vulnerabilities in the City's externally facing systems (systems connected directly to the Internet) which may be used to gain control of those systems. Externally facing systems should have the greatest level of security. Our results indicate a weakness in the information systems control processes. We then extended our testing by scanning the Financial Application server and one workstation from the Finance department. We did not find any vulnerabilities on the Financial Application server or workstation. In addition, the City should establish a means to monitor the effectiveness of their information systems control procedures, including periodic vulnerability scans.
- *Payment Card Industry Compliance* -- The City outsources its credit card processing. Any organization that processes credit cards is required to comply with the Payment Card Industry Data Security Standard (PCI-DSS), even if the processing is outsourced. The standard was developed to minimize the risk of loss due to security breaches in processing credit card transactions. Merchants which conform to the Standard pay lower transaction fees and minimize their liabilities which may result from security breaches than those that do not comply. The Standard requires varying levels of controls depending on transaction levels. In general, merchants must:
  1. Fill out a self-assessment questionnaire (SAQ).
  2. Submit the SAQ to acquiring banks.
  3. Perform quarterly external network scans and submit the results to acquiring banks.
  4. Have a full independent PCI audit performed by a Qualified Security Assessor (QSA) and submit it to acquiring banks. (Required for level 1 merchants only).

We believe the City qualifies as a Level 3 or 4 merchant due to activity levels of less than 1 million transactions and currently it need only complete and maintain the SAQ in-house. However, we understand SAQ submissions will become mandatory for Level 3 and 4 merchants within the near future. Staff have not completed the SAQ, but should do so and prepare for the submission requirement.

- *Audit/Event Logging* - . We believe this is one of the more important standards of NIST. The City does not appear to have audit logs documenting any change, addition or deletion of user accounts within the financial information system. The City should have audit/event logs of any addition, deletion or change in financial information system user accounts and the logs should be monitored by someone without the rights to effect such changes to ensure only authorized appropriate changes are made. In addition, any administrative access such as upgrades or application modifications by IT personnel, outside consultants or vendors should also be logged and reviewed.

***Current Status:***

External Scan - The vulnerabilities found were related to an online calendar application for elected officials, which was only used during development and the software has been removed. The City will also implement a procedure to run a network security vulnerability test annually. The results will then be reviewed and corrective actions taken.

**CITY OF MILPITAS  
MEMORANDUM ON INTERNAL CONTROL**

**STATUS OF PRIOR YEAR SCHEDULE OF OTHER MATTERS**

**2008-05      Information Technology Best Practices Recommendations (Continued)**

PCI Compliance - The City has requested for the SAQ and will complete the questionnaire in anticipation of the upcoming requirement.

Audit/Event Logging - Currently, there is an IS form to request an addition of new user accounts within the Financial system. The City will develop a procedure that will log and review any change or deletion of user accounts. In addition, the City will create a procedure to log and review any administrative access such as upgrades or application modification by IT personnel, outside consultants or vendors.

**2008-06      GASB Statement No. 51 Accounting and Financial Reporting for Intangible Assets  
(Effective for fiscal 09/10) - Retroactive Application Required**

Governments have different types of intangible assets, such as easements, water rights, patents, trademarks, and computer software. Easements, are referred to in the GASB 34 description of capital assets which has raised questions about whether and when intangible assets should be considered capital assets for financial reporting purposes.

The absence of specific authoritative guidance has resulted in inconsistencies in the recognition, initial measurement, and amortization of intangible assets among governments. The objective of this Statement is to establish accounting and financial reporting requirements for intangible assets to reduce inconsistencies and enhance comparability.

A summary of the statement:

- Intangible assets should be classified, accounted for and reported as capital assets, unless excluded from the scope. Guidance in this statement is in addition to existing capital asset guidance.
- GASB 51 specifically addresses the nature of intangible assets.
  - *Lack of physical substance.* An asset may be contained in or on an item with physical substance, for example, a compact disc in the case of computer software. An asset also may be closely associated with another item that has physical substance, for example, the underlying land in the case of a right-of-way easement. These modes of containment and associated items should not be considered when determining whether or not an asset lacks physical substance.
  - *Nonfinancial nature.* In the context of this Statement, an asset with a nonfinancial nature is one that is not in a monetary form similar to cash and investment securities, and it represents neither a claim or right to assets in a monetary form similar to receivables, nor a prepayment for goods or services.
  - *Initial useful life greater than one year.*
- GASB 51 excludes:
  - Assets acquired or created primarily for the purpose of directly obtaining income or profit.
  - Assets resulting from capital lease transactions reported by lessees.
  - Goodwill created through the combination of a government and another entity.



CITY OF MILPITAS  
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STATUS OF PRIOR YEAR SCHEDULE OF OTHER MATTERS

2008-06      GASB Statement No. 51 Accounting and Financial Reporting for Intangible Assets  
(Effective for fiscal 09/10) - Retroactive Application Required (Continued)

- Recognition of an intangible asset occurs only if it is considered identifiable. That is when either of the following apply:
  - The asset is separable from the government. That is it can be sold, transferred, licensed, rented, or exchanged.
  - The asset arises from contractual or other legal rights, regardless of whether transferable or separable.
- Specific conditions must present to recognize internally generated intangibles. Capitalization of costs begins after all of the following criteria are met:
  - Determination of specific objectives of the project and the nature of the service capacity expected upon the completion.
  - Demonstration of the feasibility that the completed project will provide its expected service capacity
  - Demonstration of the current intention, ability, and effort to complete or continue development of the intangible asset.
  - Internally generated computer software is used as an example in applying the specific conditions approach.
- Amortization lives are addressed:
  - Limited by contractual or legal provisions.
    - Renewal periods for rights may be considered if there is evidence that the government will seek and be able to achieve renewal and that any anticipated outlays to be incurred as part of achieving the renewal are nominal. Such evidence should consider the required consent of a third party and the satisfaction of any conditions required to achieve renewal.
  - An indefinite life (no amortization) is permitted so long as there are:
    - No limiting legal, contractual, regulatory, technological, or other factors, and
    - No subsequent change in circumstances.
    - A permanent right-of-way easement is an example.

*Retroactive Application* -- For GASB 34 Phase I & II governments, retroactive reporting is **required** for intangible assets acquired in fiscal years ending after June 30, 1980. Retroactive reporting is not required for intangible assets with indefinite useful lives as of the effective date of this Statement nor for internally generated intangibles.

Retroactive reporting for Phase III governments is not required.

***Current Status:***

The City will develop procedures to address the new GASB.

**CITY OF MILPITAS  
MEMORANDUM ON INTERNAL CONTROL**

**STATUS OF PRIOR YEAR SCHEDULE OF OTHER MATTERS**

**2008-07      GASB Statement No. 53   Accounting and Financial Reporting for Derivative Instruments (Effective for fiscal 09/10)**

This Statement is intended to improve how state and local governments report information about derivative instruments in their financial statements. Specifically, GASB 53 requires governments to measure most derivative instruments at fair value in their financial statements that are prepared using the economic resources measurement focus and the accrual basis of accounting (proprietary and entity-wide financial statements). Governments enter into derivative instruments as investments; as hedges of identified financial risks associated with assets or liabilities, or expected transactions (that is, hedgeable items); or to lower the costs of borrowings. Governments often enter into derivative instruments with the intention of effectively fixing cash flows or synthetically fixing prices. Common types of derivative instruments used by governments include interest rate and commodity swaps, interest rate locks, options (caps, floors, and collars), swaptions, forward contracts, and futures contracts. In addition, this standard addresses hedge accounting requirements.

***Current Status:***

The City's investment policy prohibits investment in derivative investments. The City's debt policy does not specifically disallow issuance of variable rate debt, but the City will implement the provisions of GASB 53, if applicable in fiscal year 2010.

## REQUIRED COMMUNICATIONS

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September 18, 2009

To the City Council of  
the City of Milpitas, California

We have audited the financial statements of the City of Milpitas as of and for the year ended June 30, 2009 and have issued our report thereon dated September 18, 2009. Professional standards require that we advise you of the following matters relating to our audit.

**Financial Statement Audit Assurance:** Our responsibility, as prescribed by professional standards, is to plan and perform our audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit in accordance with generally accepted auditing standards does not provide absolute assurance about, or guarantee the accuracy of, the financial statements. Because of the concept of reasonable assurance and because we did not perform a detailed examination of all transactions, there is an inherent risk that material errors, fraud, or illegal acts may exist and not be detected by us.

**Other Information Included with the Audited Financial Statements:** Pursuant to professional standards, our responsibility as auditors for other information in documents containing the City's audited financial statements does not extend beyond the financial information identified in the audit report, and we are not required to perform any procedures to corroborate such other information. Our responsibility also includes communicating to you any information that we believe is a material misstatement of fact. Nothing came to our attention that caused us to believe that such information, or its manner of presentation, is materially inconsistent with the information, or manner of its presentation, appearing in the financial statements. This other information and the extent of our procedures is explained in our audit report.

**Accounting Policies:** Management has the responsibility to select and use appropriate accounting policies. A summary of the significant accounting policies adopted by the City is included in Note 1 to the financial statements. There have been no initial selections of accounting policies and no changes in significant accounting policies or their application during 2009. As described in notes to the financial statements, during the year, the City implemented the following new standards:

## CITY OF MILPITAS

### REQUIRED COMMUNICATIONS

**GASB Statement No. 49 - Accounting and Financial Reporting for Pollution Remediation Obligations** – This Statement establishes financial reporting of obligations for pollution remediation. There was no material effect on the financial statements from the implementation of this statement.

**GASB Statement No. 50 Pension Disclosures — an amendment of GASB Statements No. 25 and No. 27** – This Statement amends prior year disclosures for cost sharing defined benefit pension plans by requiring among other things, funding trend data for cost sharing pools. Minor modifications were made to Note 11 to the financial statements to incorporate the requirements of the Statement.

**Unusual Transactions, Controversial or Emerging Areas:** No matters have come to our attention that would require us, under professional standards, to inform you about (1) the methods used to account for significant unusual transactions and (2) the effect of significant accounting policies in controversial or emerging areas for which there is a lack of authoritative guidance or consensus. There have been no initial selections of accounting policies and no changes in significant accounting policies or their application during 2009.

**Estimates:** Accounting estimates are an integral part of the financial statements prepared by management and are based on management's current judgments. Those judgments are normally based on knowledge and experience about past and current events and assumptions about future events. Certain accounting estimates are particularly sensitive because of their significance to the financial statements and because of the possibility that future events affecting them may differ markedly from management's current judgments. The most sensitive accounting estimates affecting the financial statements are the fair value of investments, depreciation and compensated absences.

*Estimated Fair Value of Investments:* As of June 30, 2009, the City held approximately \$212 million of cash and investments as measured by fair value as disclosed in Note 3 to the Financial Statements. Fair value is essentially market pricing in effect as of June 30, 2009. These fair values are not required to be adjusted for changes in general market conditions occurring subsequent to June 30, 2009.

*Estimated Depreciation:* Management's estimate of the depreciation is based on useful lives determined by management. These lives have been determined by management based on the expected useful life of assets as disclosed in Note 8 to the financial statements. We evaluated the key factors and assumptions used to develop the depreciation estimate and determined that it is reasonable in relation to the basic financial statements taken as a whole.

*Estimated Compensated Absences:* Accrued compensated absences, which are comprised of accrued vacation and sick leave, is estimated using accumulated unpaid leave hours and hourly pay rates in effect at the end of the fiscal year, and are disclosed in Note 12 to the financial statements. We evaluated the key factors and assumptions used to develop the accrued compensated absences and determined that it is reasonable in relation to the basic financial statements taken as a whole.

## CITY OF MILPITAS

### REQUIRED COMMUNICATIONS

**Disagreements with Management:** For purposes of this letter, professional standards define a disagreement with management as a matter, whether or not resolved to our satisfaction, concerning a financial accounting, reporting, or auditing matter that could be significant to the City's financial statements or the auditor's report. No such disagreements arose during the course of the audit.

Management informed us that, and to our knowledge, there were no consultations with other accountants regarding auditing and accounting matters.

**Retention Issues:** We did not discuss any major issues with management regarding the application of accounting principles and auditing standards that resulted in a condition to our retention as the City's auditors.

**Difficulties:** We encountered no serious difficulties in dealing with management relating to the performance of the audit.

**Audit Adjustments:** For purposes of this communication, professional standards define an audit adjustment, whether or not recorded by the City, as a proposed correction of the financial statements that, in our judgment, may not have been detected except through the audit procedures performed. These adjustments may include those proposed by us but not recorded by the City that could potentially cause future financial statements to be materially misstated, even though we have concluded that the adjustments are not material to the current financial statements.

We did not propose any audit adjustments that, in our judgment, could have a significant effect, either individually or in the aggregate, on the City's financial reporting process.

**Uncorrected Misstatements:** Professional standards require us to accumulate all known and likely misstatements identified during the audit, other than those that are trivial, and communicate them to the appropriate level of management. We have no such misstatements to report to the Council.

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This report is intended solely for the information and use of the audit committee, City Council, and management and is not intended to be and should not be used by anyone other than these specified parties.

*Mane Associates*

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